FX Daily: ReArming the euro

The euro has surged after European leaders announced big spending plans for defence and infrastructure. This comes at a time when President Trump acknowledges that tariffs are causing a 'little disturbance' to the US economy. Whether EUR/USD needs to trade substantially higher (e.g., to 1.08) will largely depend on whether US activity dips further

European Commission President Ursula von der Leyen addressed the media in Brussels yesterday following the announcement of a new major defence spending package for Europe

USD: Verging on the untradable

The DXY trade-weighted dollar index broke decisively under 106 yesterday as European currencies rallied on the prospects of major fiscal stimulus. Critics say that European leaders only react in a crisis – and certainly, the prospect of the US withdrawing its security umbrella from Europe is a crisis. The two significant events here yesterday were: a) the European Commission triggering national escape clauses from the Stability and Growth Pact, which could unlock EUR650bn of national spending and other measures totalling EUR800bn, plus b) German leaders agreeing on a suspension on the debt brake and unleashing a EUR500bn infrastructure fund.

Expect more focus on the above at a European Council meeting today. The prospects of significant European fiscal stimulus come at a time when new US tariffs were dragging many global equity markets some 2-3% lower, sending two-year Treasury yields under 4.00% and undermining the dollar. In his State of the Union address overnight, US President Donald Trump warned that tariffs were going to cause a 'little disturbance'. And it's that disturbance which has weighed on US activity and the dollar so far this year. In fact, the terminal rate for the Fed easing cycle has been repriced to 3.50% from 3.75% over the last four weeks alone.

Not helping investors has been the whipsawing on tariff policy. USD/CAD traded over 1.45 a couple of times yesterday as a US-Canada trade war broke out. Yet later in the day, US Commerce Secretary Howard Lutnick said that the US could announce, potentially today, a pathway for tariff relief based on Canada and Mexico's position in the USMCA accord. It really is hard to take a definitive position on all this. However, we would say that the new US administration has earmarked significant tariff revenues for its policy programmes meaning that tariffs may well be slow to reverse and look highly likely to be broadened in April.

Where does this leave the dollar? It is probably still a little vulnerable to any weaker US activity data through March before the tariff story once again dominates in April. The focus this week will therefore be on Friday's February US jobs report. Before then, today sees the ADP employment figures, but also the ISM Services index. The latter occasionally moves markets. In theory, this services index should be less affected by tariff noise and, barring any surprise weakness, today's US data should not prove a threat to the dollar.

DXY looks vulnerable to the 105.10/40 area – but a major clear-out of dollar longs to the 104.00 area probably only comes on a significant miss in Friday's NFP report.

Chris Turner

EUR: A fiscal coalition of the willing

As above, EUR/USD broke decisively higher on prospects of a fiscal bazooka out of Europe. The speed with which the Europeans are moving is impressive, especially in Germany. Expect much focus now on whether the agreed fiscal changes in Germany move swiftly and easily through parliament over the coming weeks. The prospect of large European stimulus is very present in European bond markets, where the German sovereign 2-10 year curve steepened a further 4bp yesterday.

In FX markets, we normally look at the combination of looser fiscal and tighter monetary policy as currency-positive. The slight problem for the EUR/USD story here is that the fiscal news has not moved the needle on European Central Bank policy expectations. The forward ESTR curve still prices the low point for the ECB easing cycle near 1.75%. No doubt this is a function of the global tariff threat which looks like it will be coming Europe's way next month.

We haven't been calling for such a decisive upside break in EUR/USD. We don't yet buy into this talk of the dollar losing its reserve currency status. This looks more like a cyclical decline in soft US data this year. For the near term, however, US activity data will probably be the determinant of whether we trade up to 1.0670/80 today – or outside risk to 1.0800 were payrolls to miss by a huge degree on Friday.

And now looking at a multi-month view, our quarterly forecasts in the 1.00/02 area for the second and third quarters will be hard to achieve. Instead, EUR/USD may be more of a 1.03/04 story when broader US tariffs come in next month.

Chris Turner

GBP: BoE hawks, doves and centrists speak today

At 3:30pm CET today, Bank of England MPC members Andrew Bailey, Huw Pill, Megan Greene and Alan Taylor testify to the Treasury Select Committee on February's 25bp rate cut. This comes at a time when the market is pricing just 57bp of BoE cuts this year compared to 72/73bp of easing priced for the Federal Reserve. While we ultimately think that the BoE cuts three times this year, the recent mood music from the BoE doves (e.g., Dave Ramsden) has been cautious about the need for gradual rate cuts. Sticky private sector wage growth has been the main problem.

Beyond the very dovish views of external member Alan Taylor, it is hard to see from where the dovish shock is going to emerge today. GBP/USD is close to resistance at 1.2810, above which we could see another leg higher in this rally.

Chris Turner

CZK: Inflation heading closer to CNB forecast but not allowing quick cuts

Headline inflation in the Czech Republic is expected to fall a little from 2.8% to 2.7% year-on-year according to our estimates. Inflation likely decelerated somewhat in February, primarily reflecting less potent inflation in the service sector, as price dynamics in this segment may have reached some saturation given the rapid growth seen in the past few quarters. In contrast, price dynamics in the food segment likely drove overall consumer price trends during the same month, preventing a more significant slowdown in the headline inflation rate.

The central bank expects 2.6% for February in its forecast, but January inflation already posted a 0.3ppt upside deviation from the forecast. A drop to 2.7% would therefore imply a narrowing of the deviation to 0.1ppt, which would be a positive signal for further rate cuts. On the other hand, core inflation and services are showing some weakness relative to expectations.

Overall, we believe – barring a major surprise today – that the Czech National Bank will wait for a new forecast in May and skip the March meeting. The market at this point is pricing in roughly a 35% chance of a rate cut in March and around two and a half rate cuts this year, with a terminal rate between 3.00-3.25%. From this perspective, pricing seems fair and the market has been pushing lower the last few days with the prospect of more cuts due to the global environment. In particular, longer maturities in the 2-5y tenor still have some room to go lower, but pricing seems to be getting stretched. EUR/CZK had a brief trip below 25.00 last week but otherwise seems more or less trapped in the 25.00-25.20 range. With no surprise in inflation today, we don't see much room for any changes here for now.

Frantisek Taborsky

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com